

TEACHERS' RETIREMENT BOARD

REGULAR MEETING

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SUBJECT: Deferred Retirement  
Option Plan

ITEM NUMBER: 7

ATTACHMENT(S):       

ACTION:   X  

DATE OF MEETING: May 7, 1998

INFORMATION:            PRESENTERS: Ms. DuCray-Morrill/Towers Perrin

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**SUMMARY**

The Board has requested that staff present information on a Deferred Retirement Option Program (DROP). Staff believes the Board should consider this plan design feature as it considers the 1998 legislation. The design of a DROP can be designed with variations in eligibility, contributions, rights and benefits. To keep DROP as cost neutral as possible, many retirement systems require members to reach normal retirement age before becoming eligible to elect DROP.

The traditional DROP plan consists of the following characteristics:

1. Freezing the member's monthly retirement allowance once the DROP period is entered.
2. A lump-sum distribution of the DROP account once the member terminates employment (retires) and/or the DROP period is concluded.

When eligible members elect DROP, retirement benefits are frozen. That is to say, the member's monthly retirement allowance is calculated using age, service credit and final compensation as if retirement occurred at the time the member enters the DROP period. The monthly benefit amount, however, never leaves the retirement plan. The monthly benefit is paid into a DROP escrow account. DROP accounts are usually "nominal" accounts and all retirement fund assets are invested together.

After the member enters the DROP period, the "nominal" account is credited with the frozen monthly retirement allowance, and may be credited with employer and employee contributions, and earned interest at a guaranteed interest rate or at a variable rate depending on how the DROP is designed. (The frozen monthly retirement allowance can also be credited with any COLAs that are usually are credited to those members who retire without electing

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DROP.) The member receives the balance of the nominal account when the DROP period is over (usually 3-5 years) and/or the member terminates employment (retires). No benefit can be paid directly to the member until the DROP period is completed and/or the member actually terminates employment. This requirement prevents any in-service distribution issues with the Internal Revenue Service.

One of the most attractive features of a DROP for members is that employee contributions may be reduced or eliminated once the employee enters/begins the DROP period. This means members see an immediate increase in take home pay. If employee contributions are credited to the "nominal" account, the contributions can be made on a pre-tax (employer pickup) basis or an after-tax-basis.

Once the member stops working or the DROP period is complete, the benefit is paid in two parts: the frozen monthly retirement allowance and a lump sum from the DROP account. The lump sum feature may cause a potential increase in the member's tax liability; however, this can be avoided if the lump sum is rolled over to an IRA, or used to purchase an annuity from the retirement system.

Similarly, employer contributions may also be reduced or eliminated upon the member's entrance into the DROP period. One possible design is for the employer to contribute 50% of the contributions to the DROP account and 50% to the retirement system. The employer contributions to the retirement plan directly impact whether or not DROP is cost neutral.

DROP can be a "win-win" proposition to members, employers, and the retirement system. However, there are funding, plan-design and policy issues that must be carefully analyzed before proposing this type of benefit option. The biggest limitations of DROP are the administrative capability of the retirement system.

#### **Advantages for Members**

Members may enjoy an immediate increase in take-home pay if employee contributions to the retirement system are reduced or eliminated; or

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Member contributions can be continued to increase the lump-sum payable at the end of the DROP period;

DROP can be viewed as a "cash balance" element of a retirement plan;

Member receives a lump-sum distribution of the DROP account once employment is terminated and/or the DROP period is concluded along with a monthly retirement allowance; and

DROP provides an additional retirement option and some flexibility to retiring members.

#### **Advantages for Employers**

Employer contributions may be reduced or eliminated;

Long service employees who have reached normal retirement age are retained ; and

DROP provides an additional retirement option which employers can cite to attract new teachers.

Attached is a detailed presentation of the DROP by STRS' Benefits Consultant, Catherine Cole of Towers Perrin.

# **DEFERRED RETIREMENT OPTION PLANS**

**California State Teachers' Retirement System**

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## **Introduction**

Deferred Retirement Option Plans (DROPs) provide a partial lump sum payment from a defined benefit plan. For the past 15 years, they have been used by the public sector, implemented primarily by safety officer systems. Recently, interest has expanded to teacher and general employee groups.

There are various reasons for the interest in DROPs. A major advantage is giving members the opportunity to control their retirement dollars. Even if the DROP is designed to be cost neutral, employees like the flexibility of having immediate control of some of their benefit dollars for estate planning or retirement enjoyment. The key issues involve cost, administration and communication.

This paper offers examples of DROP programs and reviews the design, cost implications, and basic legal issues. Throughout, the objectives for these programs and member reaction will be shared.

## Deferred Retirement Option Plans

At their simplest, DROPs give employees the ability to take part of their retirement income as a lump sum rather than a monthly benefit. However, there are almost an infinite number of ways to structure DROPs because of the various ways to calculate monthly benefits and lump sum payments. Of course, the decisions made regarding the design of the DROP have a substantial impact on the cost.

A DROP is cost-neutral if it does not affect the normal cost or actuarial accrued liability of the system. If a DROP is designed to simulate earlier retirement and early retirement is subsidized, the cost to the system increases when a DROP is elected. For the DROP to be cost-neutral on an individual basis, the individual's DROP benefit would need to be designed to be less valuable than the subsidized early retirement benefit. Alternatively, some of the contributions for the member, paid by either the member or the employer during the DROP period, would be used to pay for the additional cost. Rather than be cost-neutral on an individual basis, a DROP could be cost-neutral on a system-wide basis if the additional benefit value for those who enter the DROP period early is offset by cost savings to the system for members who delay retirement because of the DROP.

### Concept

Let's start with a simple example. In a system providing a DROP, a member eligible for early or normal retirement elects through the system to begin the DROP period. But the member continues to work for the employer and receives no payments until actual retirement.

The member's benefit is calculated based on all the plan provisions in place when the DROP is elected. If no COLA is applied, that monthly benefit is exactly what the member will receive as an annuity when the member actually leaves employment. By agreeing to a frozen annuity, the member will also receive a lump sum payment at ultimate retirement. Typically, the lump sum payment will equal the monthly benefit payments accumulated with interest from the date of benefit calculation until retirement.

When a member enters a DROP period, the defined benefit is frozen and an escrow account begins. The escrow account accumulates monthly benefit payments and is available at retirement, along with the frozen monthly benefit. Consequently, a DROP is a way to offer a partial lump sum feature without adding a full lump sum optional form of payment. [Regarding administration, the escrow account can be maintained within the cash balance feature of the STRS program.]

The feature described above is sometimes called a Forward-DROP: the member locks into the program while still working. A more recent development is a Back-DROP: the member does not decide until full retirement to elect the DROP. Instead, the members ask the system to calculate the benefit as if they had initiated the DROP process at a specified date in the past. The Back-DROP gives members the most flexibility and avoids locking them in earlier. At the same time, it may generate the most anti-selection, allowing the member to elect this feature when it is financially most favorable to the member and least favorable to the system.

Members like DROPs because of the large lump sum payments that become available to pay off a mortgage, buy a boat or retirement home, or pay for college. They like the flexibility of selecting a beneficiary or death benefit option that may not be available from the retirement fund. *Of course, a member electing a DROP may end up with lower benefits by missing out on benefit improvements or large pay increases during the DROP period, high inflation after retirement with an automatic COLA, or living a long life.*

From an actuarial perspective, the simplest way to offer a lump sum is to provide a payment which is actuarially equivalent to a reduction in monthly benefits. For example, a member with a monthly life annuity of \$1,000 per month worth \$120,000 over an expected lifetime could elect to reduce the monthly payment to \$900 and receive 10% of the present value, or \$12,000 in a lump sum payment. This may be the only way to ensure each member pays the full cost of the lump sum, without increasing or decreasing the cost to the system.

A DROP is more attractive than an actuarial equivalent lump sum payment for some of the following reasons:

- # Members do not understand present value concepts and don't like to elect a reduced monthly pension.
- # Members can keep their monthly benefit earned to date and work for a few more years to build up a DROP account balance. Members view a DROP as an add-on.
- # Most retirement plans do not charge the full annual actuarial reduction for early retirement. To the extent that early retirement is subsidized, a DROP allows employees to capture the value of the subsidy without actually retiring early. For example, the STRS early retirement reduction of 0.5% per month from age 60 to 55 and 0.25% per month from age 55 to 50 does not recognize the true cost of early retirement. A more cost neutral charge would be 0.67% per month from age 60 to 55 and 0.33% per month from age 55 to 50. (Based on GA94 female mortality, 8% interest and 2% COLA).
- # Some employers want to keep more senior employees working longer. For example, communities may want to see older police officers patrolling along with younger officers. They view the DROP as a way to encourage older employees to work for a few more years with the DROP lump sum as an incentive. (There are other ways to motivate delayed retirement, such as increasing the 2% formula to 2.1% or 2.2% for years of service after age 60.)
- # An employer delays recruiting and training costs for new employees if members defer retirement due to the DROP. Even though the older employee may earn a higher pay, these deferred costs may make the DROP financially advantageous to the employer; especially if employer contributions to the fund are decreased during the DROP period.



# In a Forward-DROP, employers can anticipate the need to replace staff. This may help them in recruiting and training, especially when there may be a long lead time.

Given a neutral cost impact, employers generally like the DROP because of the reasons stated above. However, employers should consider how delayed retirement might affect opportunities for younger workers.

### Example of Full DROP For STRS

Year	Age	Final Average Pay	Service	Annual Pension	
				Retire at 60	Retire at 65
1998	60	\$40,000	25	\$20,000	
1999	61	42,000	26	20,400	
2000	62	44,000	27	20,800	
2001	63	46,200	28	21,200	
2002	64	48,500	29	21,600	
2003	65	51,000	30	22,000	\$30,600

### DROP Escrow Account – Enter at 60 and Leave at 65

Year	Benefit	Member Contribution	5% Interest	End-of-Year Total
1999	\$20,000	\$3,360	\$ 584	\$23,944
2000	20,400	3,520	1,795	49,659
2001	20,800	3,696	3,095	77,250
2002	21,200	3,880	4,490	106,820
2003	22,000	4,080	5,993	138,893*

Assumptions: Contribution equals 8% of final pay. Interest credited assuming mid-year allocation. Salary increases are 5%.

\*Ending balance would increase to \$159,790 with employer contributions also allocated.

## Specific Design Features

When reviewing the following design features, recognize that choices which maximize both the monthly benefit and the DROP escrow account are generally most beneficial to the member but may increase costs to the system. Features that provide more flexibility to the member are also likely to be more attractive to the member, but may introduce anti-selection or additional administrative requirements for the system.

**Contributions.** What happens to the member and employer contributions during the DROP period? Most commonly, the employer contribution is continued because the member is in the workforce. In some cases, the employer has negotiated to contribute somewhat less, such as one-half, or the employer contribution is continued in full with part of it allocated into the DROP escrow account. Usually the full contribution is not allocated to the DROP escrow account because of increased costs due to the DROP. Some of the contribution may need to be credited to the system as a whole to offset these increased costs.

Though it is unusual, in some cases member contributions are continued during the DROP period, and are held by the system to pay for benefits in general. More often, if member contributions are continued during the DROP period, they are allocated to the escrow account.

Some systems cease member contributions during the DROP period. This was especially important for "pick-up" contributions that decreased taxable compensation, used for Section 415 limitation purposes. With the 100% of compensation limit no longer a factor for Section 415, suspension of member contributions is not as critical. Eliminating employee contributions during the DROP period has the advantage of increasing the members' take-home pay, but members close to retirement may be more interested in continuing contributions in exchange for a larger lump sum payment. Therefore, some DROP programs continue member contributions and allocate them to the DROP escrow account.

**Service and Pay for Monthly Benefit Calculation.** The service and pay used to calculate benefits when a member retires appear to be straightforward. But even these simple provisions may need to be considered for a DROP. When a member actually retires, there may be additional service credits added to the pension system for remaining sick leave, or the final average pay may recognize a lump sum termination payment for unused vacation. The member is not actually retiring and locking in these amounts from the employer. If the system counts accrued time or pay on the books, the member could get double credit – both from the pension system at the beginning of the DROP period and also from the employer if they continue to work and use up the vacation or sick leave service. This has the impact of increasing costs to the employer.

There are other complexities even in the case of a Back-DROP when the member simultaneously retires from the workforce and elects a retroactive date for entering the DROP period. For example:

- # If a member has one year of sick leave or vacation that is converted to service at retirement, should this service be added on and then subtracted to calculate service before the DROP period?
- # If there is one year of accrued sick leave or vacation, should the service be added on and then subtracted to determine the ending period for averaging final pay?
- # Should a member be eligible for a retroactive DROP when first eligible to retire? Usually, in a Back-DROP the members may choose only a retroactive date when they would have been eligible to retire.

**Irrevocable Election.** Should a member have the option to void a DROP election? Generally this is not allowed because of anti-selection. Anti-selection occurs when a member chooses a benefit that is financially favorable to the member but increases the cost to the system.

**Length of DROP.** Traditionally, there has been a limit to the DROP period, for example, two to five years. When a member has elected a DROP, they may have simultaneously filed with the employer a request to retire at a specific date in the future. That date could not be extended but the member could retire earlier. Employers with long lead times to train employees may like the ability to better predict when members will retire.

One reason for the limit is the concern that members should not be given a large lump sum option that results in a large monthly benefit reduction. Limiting the DROP period limits the lump sum and the chance for "the wrong decision" to be made. Actuarial uncertainty has also been a factor. These are complex arrangements that may either increase or decrease costs depending on many factors.

What happens when a member reaches the end of the DROP period and wants to keep working and the employer wants to retain the talent? If they are allowed to work, how does this affect the lump sum payment and the monthly benefit? The escrow account could continue to accrue with interest only, the monthly benefit could grow with additional years of service, or the member could be treated like a new employee (with prior service used for vesting and retirement eligibility). The reason for the last approach is to avoid higher future final average pay from increasing the frozen benefit calculated at the beginning of the DROP period. In some cases, members working beyond the DROP period revoke the DROP election, revert to the regular benefit formula, and may be penalized for this flexibility.

More recently, some systems are eliminating the limitation period. This gives a member substantially more flexibility and avoids locking the employee in to a set retirement date. Also, revoking the DROP becomes a non-issue. Before providing an unlimited DROP, the

cost impact must be carefully analyzed. If employer contributions continue and are used to decrease overall costs and are not allocated to the escrow account during the DROP period, an unlimited DROP may be financially beneficial to the system.

**Monthly Benefit Accrued to DROP Escrow Account.** While most DROPs allocate 100% of the monthly benefit to the escrow account during the DROP period, Teachers Retirement System of Texas (TRS) contributes about 79%. Presumably this amount was designed to generate a neutral cost for the DROP. (Some DROPs increase costs because of subsidized early retirement. The Texas TRS provides for unreduced retirement when age plus service equals 80.) Special one-time payments, such as a 13<sup>th</sup> check, may also be allocated to the DROP escrow account.

**COLA.** If an automatic or ad hoc COLA is made during the DROP period, what happens to the ultimate monthly benefit and the escrow account? Again, there is more than one option. In some systems the COLA is used to increase the monthly payment, both to the escrow account and ultimately as an annuity. In other cases, no COLA is granted until the member is in payment status to minimize the cost of the DROP.

**Interest.** The interest rate earned on the DROP escrow account could range from 0% to the rate applied to employee contributions (often about 5%) or to the actuarial return assumption (often about 8%), or the rate credited to the STRS cash balance plan. Some funds even credit interest related to the actual return on assets – with some smoothing, a floor for protection, and/or a 2% or more reduction.

Many decisions must be made regarding how often the interest accrues, whether it compounds or is simple, and whether contributions made after the beginning of the period receive any interest.

**Payout Options.** Some funds, to minimize administrative effort, require all participants to take the DROP payment in full at the date of actual retirement. Others allow deferral of a single sum payment. Some funds allow for installments with each amount and payment date set at the participant's request. Or, interest only may be withdrawn until age 70½. There may be a limit on the number of payments allowed and a requirement that payments begin all after age 59½. It is also possible to allow members to use the DROP escrow account to "buy" an annuity from the fund or purchase a COLA to protect the basic benefit.

**Active Disability Benefits.** Decisions need to be made about the benefits available if members become disabled during the DROP period. Usually, a fund will not allow members to file for disability benefits but requires them to leave the DROP period and commence retirement benefits. This decreases the cost of disability benefits to the system. However, there may be other ramifications for the employer related to workers compensation or other disability and sick leave programs.

**Active Death Benefits.** Similarly, if there are special death benefits paid from the fund at death before retirement, rules need to be established for the DROP. When members enter the DROP period, they may be required to elect an optional form of payment. Then the death benefit related to the annuity form governs. However, if

there is an additional lump sum death benefit, such as the \$20,000 death benefit payable by STRS, which ceases at full retirement, this special benefit might be continued. Alternatively, only active death benefits plus the DROP escrow account might be paid during the DROP period with the optional form elected at ultimate retirement.

**Beneficiary.** The plan should determine if a member is able to select the beneficiary for the DROP account if the member dies before it is paid out in full. Alternatively, there may be an automatic beneficiary tied to either the beneficiary connected with refund of contributions, the monthly benefit election, or a hierarchy involving dependents. Spousal consent may be required for a non-spousal designation as a primary beneficiary. Contingent beneficiaries may also be allowed.

**Optional Form of Payment.** If a member chooses the optional form of payment at the beginning of the DROP period, what happens if the family situation changes before actual retirement? Where optional forms are available, should members be allowed to change the form of payment, change their contingent annuitant in a joint and survivor form of payment, or return to the standard form of payment? What if they divorce and remarry during the DROP period? Does the new spouse have rights to a joint and survivor annuity? A member who elects a life annuity and then becomes ill during the DROP period would increase costs to the system if allowed to change to a joint and survivor form of payment. A member who elects a joint and survivor option with a pop-up feature might not be increasing costs if allowed to change the beneficiary or the optional form of payment during the DROP period. However, there are administrative and legal issues connected to allowing a change. To avoid some of these complexities, the election for the optional form may be delayed until the member retires from the workforce.

**Subsequent Design Changes.** In a Forward-DROP, what happens if there are benefit improvements for only active members or only retired members? Usually the member who has elected the DROP would get only the retiree increases. Therefore, any improvements in the formula would not apply. Any legislation should clearly indicate the impact of benefit changes on members in the DROP.

**Transition to a DROP.** When a popular feature such as a DROP is implemented, members who have recently retired or are about to retire may want the opportunity to receive a lump sum payment. This can be handled with a Back-DROP feature that reduces monthly benefits in exchange for a lump sum payment. A pure actuarial equivalent or a retroactive DROP election could be used. While rare, a window period could be opened during which this transitional election is allowed.

**Other Benefits During the DROP Period.** The member is an active employee during the DROP period. Consequently, all other benefits provided by the employer such as medical or dental coverage are usually not affected by the DROP election. Retiree health care benefits would usually commence when the member retires from the workforce.

## The Cost of DROPs

There are some obvious costs to DROPs, but there are also some hidden costs. The actuarial valuation may predict that a DROP will decrease costs when in actuality, there may be a real cost increase. Generally, unless the system receives some contribution during the DROP period or the DROP holds back some benefit attributable to the member in the DROP period, the cost to the system will increase.

Remember that the real long-term cost, or contributions, for a pension fund is benefits paid plus expenses minus investment return ( $C = B + E - I$ ). While the actuarial valuation attempts to provide an employer with a budgeting approach to pay contributions over the members' lifetimes, the actuarially determined contribution is not the real cost. A DROP can affect all of the elements of the cost equation. During the DROP period, contributions may be eliminated or added to the escrow account, rather than be available to fund all benefits. The benefit amount and form of payment are changed. There are additional expenses that are incurred to administer and communicate DROPs. The administrative cost is somewhat less for Back-DROPs because the election and calculations are all completed when the member actually retires. If lump sum payments increase, the liquidity needs of the fund and its underlying investments may change.

**Retirement Timing.** If a DROP is designed to exactly parallel retirement, then when a member elects a DROP, the fund and member are in the same financial condition as if full retirement occurred at the beginning of the DROP period. However, if members elect to enter the DROP prior to when they would have otherwise retired, the cost of the DROP to the system increases. If members all enter the DROP period when they would have retired anyway and work longer than they otherwise would have, then there is no financial effect on this type of DROP due to retirement timing. However, employer contributions to the fund usually continue during the DROP period. Therefore, the DROP helps the system if members delay retirement beyond when they would have retired if there had been no DROP.

However, if members leave the workforce at the same time they would have, whether or not a DROP is available, then adding a DROP effectively decreases the average retirement age for the fund. Because the STRS provides unreduced benefits at age 60 and incorporates an early retirement subsidy, this earlier average retirement age increases the present value of benefits payable. If all contributions cease beginning on the members' DROP date, then costs increase. Usually, some employer contributions continue to the fund during the DROP period to pay for the increased cost of benefits.

Because of the cost of decreasing the average retirement age, some DROPs set a minimum DROP entry age, such as the current average retirement age or eligibility for unreduced benefits. This makes the DROP unavailable to some members, but may allow more favorable features to the members who can take advantage of it.

**Utilization of the DROP.** Depending on the designs and the various workforces involved, we have seen utilization vary from about 50% to close to 100%, with public safety populations using the DROP more heavily than other groups. Utilization varies by

age and length of service (especially where there are cliffs for eligibility or service caps). If experience is different from the actuarial assumption for utilization, actuarial gains or losses will occur. When a DROP is first implemented the actuary and the Board may want to choose a conservative assumption until experience develops. If the DROP is expected to increase costs, the actuary may assume that all members elect the DROP and do not change their ultimate retirement date. They may also use a salary scale that more explicitly recognizes expected variations in pay increases with service or age.

**Pay Increases.** Many actuaries and Boards choose actuarial assumptions that are somewhat conservative or recognize the long-term future rather than the most realistic expectation for the next few years. As an example, a level salary scale predicting 6% pay increases for every year into the future for all employees may be assumed. When actual pay increases are less than assumed for a fund without a DROP, actuarial gains occur and ultimate costs are lower than initially predicated.

This conservative approach may be desirable for setting pay increase assumptions, but could mask the true cost of a DROP. When actuaries estimate the cost of adding a DROP, they are assuming that pay increases during the DROP period are ignored. If these pay increases are expected to be high, the fund is expected to save more money by freezing pay. These large savings may more than offset the cost of earlier effective retirements due to the DROP, making the DROP appear to save money.

But what if employees eligible for retirement usually receive a lower pay increase, such as 3%? Then the actuary is systematically overstating the savings from the frozen pay used for the DROP calculation.

The overstatement of savings may be even worse during a period of pay freezes. In this case, members are not losing any pay-related value during the DROP period because their benefits would not reflect higher pay even if they had not elected the DROP.

**Decrease in Disability Claims.** If a substantial number of members join the DROP and are, therefore, not eligible for disability benefits, then the incidence of disability and related costs decrease. If the existence of the DROP keeps members working to accrue a DROP rather than pursue a possible disability claim, then the incidence of disability will also decrease.

**Example of a High Cost DROP.** A DROP was implemented for a state-wide group about 10 years ago that generated higher costs than originally determined by the actuary. The fund allowed for unreduced early retirement, had automatic COLAs that were applied during the DROP period, credited interest to the DROP escrow account, stopped member contributions during the DROP period, and cut the employer contributions by 50% during the DROP period. For DROP members, benefits increased and contributions decreased. Therefore, larger contributions for the entire system were required.

**Example of a DROP which Decreased Costs.** A Back-DROP (with no Forward-DROP) was implemented for a city. The monthly benefit was calculated based on pay

and service on a date up to 24 months before retirement. The lump sum payment was set equal to the monthly benefit times the number of months in the DROP period, e.g., 24 months. This approach is simple to understand and very popular with members. Because it is not a Forward-DROP and has no escrow account, certain features don't appear unfavorable. For example, there is no interest earned, automatic COLAs are not applied, 13<sup>th</sup> checks are not paid during the DROP period, and contributions are not reduced or allocated to the DROP escrow account. The DROP lump sum payment is simply the monthly benefit times the number of months. Despite these drawbacks, a financial columnist in a local newspaper praised this Back-DROP as an advantageous feature that members should consider electing.

**Administration.** To make the new program a success, administrative processes and software must be updated to recognize the need to model different scenarios. For example, if a member is allowed to choose a Back-DROP with a duration of up to 24 months, then 25 retirement calculations (no DROP plus a DROP period with a length of 1 to 24 months) may be needed rather than the one calculation currently being performed. Also, whereas only five optional forms of payment may have existed in the past, the system must now administer the various lump sum/installment/annuity purchase variations that become available under the DROP.

In a forward DROP the administrative effort is even larger. Where the election is irrevocable, intensive personalized communication covering various potential scenarios (regarding length of DROP and the effect of future pay increases) may need to be modeled for each member. Several counseling sessions, possibly involving the spouse and video-taping, may be essential to minimize misunderstandings and prove the content of discussions. Then during the DROP period, a member may continue to ask for modeling regarding the timing of ultimate retirement and the best form of payment of the DROP. And, the individual account must be maintained.



## Legal Issues

While it would be impossible to document all of the federal, state, and local issues surrounding DROP programs, following are some of the issues related to the retirement program. Legal opinions and possibly IRS determinations should be requested before proceeding with a DROP. Employment issues should also be explored:

- # Based on federal law applicable to public plans, accrued benefits do not need to be preserved. However, many states require preservation of accrued benefits or even projected benefits. In a Forward-DROP, the accrued benefit is preserved with an additional lump sum added, so that the requirement to preserve the accrued benefit is likely to be met. However, there is no guarantee that the present value of the total benefit payable at retirement is as large as the present value that would have been payable if the DROP had not been elected. To avoid a reduction, an increase in the lump sum payment may be made.
- # All defined benefit plans must have definitely determinable benefits, so that no feature of the plan can be interpreted by the employer to vary benefits (except with a plan amendment or similar Board action affecting all members). It appears that member elections to change benefits are permissible (possibly including an election on how interest is allocated to the escrow account, e.g., a fixed rate, or a rate tied to the actual return of the total fund or a certain asset class).
- # The fund must offer an option to roll over to an IRA, or another qualified plan, the lump sum payments attributable to pre-tax contributions. After-tax contributions cannot be rolled over.
- # Basis recovery rules for after-tax contributions attribute part of the lump sum payment to after-tax contributions made by members, with the remainder attributable to monthly benefits. If the full lump sum is not payable immediately before or at the time monthly benefits begin, the after-tax contributions attributable to monthly benefits may need to be changed when each lump sum payment is made.
- # IRS Code Section 72(t) regarding the 10% additional tax on early distributions to qualified plans delineates several exceptions for this tax. If distributions are made after age 59½, due to disability, are made because an employee separated from service after age 55, or represent a series of substantially equal periodic payments for life or life expectancy, then the tax will not be imposed. Members who leave employment before age 55 and do not roll over their pre-tax lump sum to an IRA may be subject to the 10% additional tax on payments received before age 59½. There is a question whether this tax applies only to the lump sum payment of the DROP escrow account or also to the monthly benefit. Some attorneys have implied that if the DROP escrow account is paid in at least five annual installments, then this might represent substantially equal periodic payments over a life expectancy.

- Minimum distribution rules apply at age 70½ to retired members. Rollovers or periodic payments of principal and interest should commence by then.
  
- # As always, the fund should avoid giving financial advice to members regarding taxes or investments. Some funds require all members to state that they have met with a financial planner or tax advisor regarding their DROP elections. Given the irrevocable nature of the DROP and the uncertainty during the DROP period, unexpected results are possible.
  
- # Now that the 100% of taxable compensation limit of Section 415 has been repealed, the effect of DROPs on maximum benefits is less of an issue. However, long-service, highly compensated employees who retire early may continue to be subject to the dollar limit of Section 415. When a DROP is elected, the lump sum payment must be restated as an annuity amount and added to the monthly benefit attributable to pre-tax contributions. The resulting total annuity value is then tested for Section 415. If the total monthly benefit is limited, the fund's language should determine if the lump sum payment or the monthly benefit is reduced. If a reduction is required, the remaining amount could be held in escrow until Section 415 dollar limits increase with inflation. If the total benefit is not limited by Section 415, the full DROP escrow account may be paid in one lump sum, even if it is larger than the Section 415 dollar limit (currently \$130,000).
  
- # Assuming that a DROP is accrued within a defined benefit plan, the defined contribution Section 415 limits do not apply. Therefore, the contribution to the DROP escrow account is not subject to the 25% of pay or \$30,000 annual maximum limiting contributions to defined contribution plans.
  
- # Care should be taken in the design of the DROP to avoid the escrow account from becoming a defined contribution plan for IRS purposes.
  
- # It may be possible for disabled retirees to seek reemployment and ADEA "reasonable accommodations" to participate in the DROP for a limited time to take advantage of the enhanced feature.
  
- # An ongoing defined benefit plan generally cannot pay out benefits to active employees. Therefore, the DROP escrow account is not available until termination of employment. While no known DROP offers loans, this may be possible during employment.

## **Conclusion**

There are many variations to DROP programs. As with any potential benefit change, it is imperative to review the objectives for the fund, the members, and the employer. Then, a specific program to meet those objectives can be designed and priced. For example, if neutral cost and simplicity of administration and communication are vital, then a straightforward Back-DROP might be most appropriate. If deferring the retirement age of employees is vital, a Forward-DROP with more incentives may be appropriate. Whatever the design, experience shows that the DROP will be very popular, with more than half the members likely to be interested.